

Private foundations; excess business holdings; effective control. For purposes of computing the 35 percent permitted holdings rule of section 4943(c)(2)(B) of the Code, effective control in one or more persons who are not disqualified persons may be demonstrated by proving that some unrelated party or cohesive group of third parties, in fact, exercises control over the business enterprise. It is not enough to show that the private foundation and disqualified persons cannot exercise such control.

ISSUE

In the situations described below, is the 35 percent permitted holdings rule of section 4943(c)(2)(B) of the Internal Revenue Code applicable to the holdings of the private foundation?

FACTS

P is exempt from federal income tax under section 501(c)(3) of the Code and is a private foundation under section 509(a). Corporations M and N each have outstanding 100x shares of voting stock, with each share entitling the holder thereof to one vote. M and N are business enterprises within the meaning of section 4943(d)(4) of the Code and section 53.4943-10(a) of the Foundation Excise Tax Regulations.

Situation 1.

P holds 15x shares of M voting stock, and disqualified persons with respect to P, within the meaning of section 4946(a) of the Code, hold 20x shares of M voting stock. The remaining 65x shares of M voting stock are held by C, who is not a disqualified person with respect to P. By virtue of C's ownership of 65 percent of the M voting stock, C has elected a majority of the board of directors of M.

Situation 2.

P holds 15x shares of N voting stock, and disqualified persons with respect to P hold 20x shares of N voting stock. The remaining 65x shares of N voting stock are held by a large number of individuals, none of whom is a disqualified person with respect to P. There does not exist any voting trust, contractual arrangement, or other similar agreement between any of these individuals relating to their stock voting rights. None of these individuals alone has sufficient voting stock holdings in N to direct or cause the direction of the management and policies of N, nor has one of them historically elected the majority of N's board of directors. P's holdings of N stock are not protected by any of the special transitional rules of sections 4943(c)(4), (5), and (6) of the Code.

LAW

Section 4943(a)(1) of the Code imposes a tax on the excess business holdings of a private foundation equal to 5 percent of the value of such holdings.

Section 4943(c)(1) of the Code states that the term "excess business holdings" means the amount of stock or other interest in a business enterprise that the foundation would have to dispose of a person other than a disqualified person for its remaining holdings to be permitted holdings.

Section 4943(c)(2)(A) of the Code provides that the permitted holdings of a private foundation in a business enterprise are 20 percent of the voting stock reduced by the percentage of the voting stock owned by all of the foundation's disqualified persons.

Section 4943(c)(2)(B) of the Code and section 53.4943-3(b)(3) of the regulations provide that section 4943(c)(2)(A) shall be applied by substituting 35 percent for 20 percent if--

(i) the private foundation and all disqualified persons together do not own, actually or constructively, more than 35 percent of the voting stock in the business enterprise, and

(ii) the foundation establishes to the satisfaction of the Commissioner that effective control of the business enterprise is in one or more persons (other than the foundation itself) who are not disqualified persons.

Section 53.4943-3(b)(3)(ii) of the regulations provides that the term "effective control" mean the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a business enterprise, whether through the ownership of voting stock, the use of voting trusts, or contractual arrangements, or otherwise. It is the reality of control which is decisive and not its form or the means by which it is exercisable. Thus, where a minority interest held by individuals who are not disqualified persons has historically elected the majority of a corporation's directors, effective control is in the hands of those individuals.

ANALYSIS

In Situation 1, C holds a majority of the voting stock of M, and C has elected a majority of the board of directors of M. Under these circumstances, P has established that effective control of M, within the meaning of section 4943(c)(2)(B) of the Code and section 53.4943-3(b)(3)(ii) of the regulations, is in the hands of C. Thus, since the holdings of P and all disqualified persons do not exceed 35 percent of the voting stock of M, the 35 percent permitted holdings rule of section 4943(c)(2)(B) of the Code is applicable. It follows that P is not in an excess

business holdings position with respect to its holdings of M voting stock.

In Situation 2, on the other hand none of the individuals holding the 65 percent of N voting stock, not in the hands of the foundation or disqualified persons, alone has sufficient voting stock holdings in N to direct or cause the direction of the management and policies of N, nor has one of these individuals historically elected the majority of N's board of directors. Also, none of these individuals has entered into any voting trust, contractual arrangement, or other similar agreement resulting in their combined control of N. Under these circumstances, P has not established that effective control of N, within the meaning of section 4943(c)(2)(B) of the Code and section 53.4943-3(b)(3)(ii) of the regulations, is in the hands of third persons who are not disqualified persons with respect to P.

Even if P were to establish that P and its disqualified persons cannot exercise effective control of N because of their minority voting stock interest in N, and that they have not, in fact, exercised effective control over N, the 35 percent rule would not be applicable. Section 4943(c)(2)(B)(ii) of the Code and the regulations thereunder require affirmative proof by a private foundation that some unrelated third party, or a group of third parties does, in fact, exercise effective control over the business enterprise in question.

Accordingly, the 35 percent permitted holdings rule of section 4943(c)(2)(B) of the Code is not applicable to Situation 2. Thus, because disqualified persons hold 20 percent of the N voting stock, P is in an excess business holdings position with respect to its 15 percent ownership of N voting stock.

HOLDINGS

In Situation 1, because foundation P established that C, who is not a disqualified person, exercised effective control over the M corporation, the 35 percent permitted holdings rule of section 4943(c)(2)(B) of the Code is applicable.

In Situation 2, because P has not established that effective control of the N corporation is in one or more third persons who are not disqualified persons, the 35 percent rule of section 4943(c)(2)(B) is not applicable.